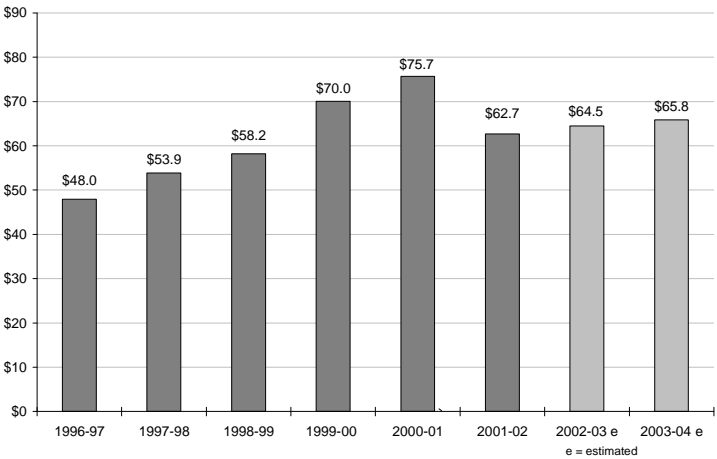


REVENUE ESTIMATES

Major General Fund Taxes and Licenses
(Dollars in Billions)



Because the anticipated recovery of the U.S. and California economies has not yet materialized, the decline in the State's revenues was more pronounced than what was expected at the time the 2002-03 May Revision was prepared. Since enactment of the 2002 Budget Act, the General Fund revenue forecast for



major taxes and licenses has decreased by \$7.7 billion for the past year and current year combined. In addition, a decline of 5.5 percent in revenues, or \$4 billion, to \$69.2 billion is expected for 2003-04. When the three years are compared to the estimates made last May without the revenue measures proposed in this Budget, the three-year drop amounts to \$17.7 billion.

As has been noted during the past year, the State's remarkable revenue growth in recent years was driven by stock market related gains, while the current fall-off largely reflects the market's decline. Revenues began to weaken beginning early in 2001 and year-over-year losses in personal income tax withholding are believed to be attributable primarily to the loss of stock option income, which plunged with the slowing economy and the market's retreat. Taxpayers are also anticipating less non-wage income—primarily capital gains—which has eroded estimated payment receipts. Similarly, consumers have cut back, resulting in a deterioration in purchases of taxable goods. This softness in revenues is expected to continue until mid-2003, when modest growth is expected to resume.

Major Revenue Sources

Personal income tax revenues are projected to be \$32.9 billion in 2002-03 and \$33.6 billion in 2003-04. Preliminary data indicate that capital gains peaked in 2000 before plunging an estimated 60 percent in 2001. Given the general weakness in the market during 2002, this forecast assumes capital gains will decline by an additional 15 percent in 2002 before returning to positive growth of 7 percent in 2003.



Sales and use tax revenue is forecast at \$22.3 billion in 2002-03 and \$23.2 billion in 2003-04. Taxable sales for 2002 are expected to be down by 2.2 percent compared to 2001. Sales growth is expected to resume during 2003, but at a modest pace—up 3.4 percent—due to a slowly recovering economy during the first half of the year. In 2004, the rate of increase is expected to accelerate to 5.6 percent, consistent with economic growth.

Corporation tax revenues are expected to total \$6.5 billion in 2002-03 and \$6.4 billion in 2003-04. Taxable profits are estimated to increase by 0.6 percent in 2002 before rebounding 10.9 percent in 2003. Revenue growth will be held down somewhat by credit usage and S-corporation activity.

The Governor's Budget revenue forecast also reflects the following proposals:

- ◆ **Regulated Investment Companies**—The Budget proposes to prevent banks from utilizing Regulated Investment Companies to avoid California tax by improperly sheltering income, thereby increasing revenues by \$45 million in 2003-04.
- ◆ **Corporation Tax Subpart F Income Exclusion**—The Budget proposes to clarify that existing law does not allow certain corporations to exclude a portion of their income, called Subpart F income, from a water's edge combined report. The Budget also proposes to conform to federal law in the coordination of Subpart F income and U.S.-source income. Because these proposals would clarify existing law, they will have no effect on revenues. However, these changes will close potential tax loopholes.



- ◆ **Manufacturers' Investment Credit (MIC) Clarification**—The Budget proposes clarifying that the MIC is intended to apply to manufacturing activities as specified in the Standard Industrial Code. This proposal would increase revenues by an estimated \$50 million in 2003-04.
- ◆ **Extension of the Sunset Provision for the Manufacturers' Investment Credit**—Based on the Budget's economic forecast, decreases in manufacturing employment are expected to cause the MIC to sunset on January 1, 2004. However, the Budget proposes to revise the MIC provisions and extend the sunset date in order to continue the stimulus this credit provides for jobs and investment, thereby assisting the economic recovery.

